

**RICHARD
RUSSELL'S**

DOW THEORY LETTERS

INCORPORATED

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May 17 DJIA 1285.34; PTI 1780; A-D Ratio -15.09
May 24 DJIA 1301.97; PTI 1792; A-D Ratio -15.04

THE MARKET: The records show that over a five-year period two-thirds of all new businesses go under. For restaurants, it is even worse. Over a five-year period 90% of all new restaurants go broke. I don't know the exact figures for the investment advisory business, but my guess (from personal observations over many years) is that over any 10-year period 80% of all new advisories go to the wall.

Why is this? For restaurants it's bad location, bad management, rotten food. For most businesses it's under-capitalization and bad management or insufficient knowledge of what they are trying to do in the first place.

In the advisory business bad management, fuzzy objectives or just bad luck can send you to the cleaners. But there is another factor. Fixed scenarios have sent more advisory publications (and I'm talking about both well-established ones and new ones) to the wall than almost any other cause.

Consider this: a man wants to develop a reputation in the advisory business. How can he do it? The "easiest" way is to come out with a dramatic prediction, a startling scenario, and then publicize the devil out of that scenario. After that there's only one problem. Will the market and the economy FIT the scenario? If everything fits, the advisor is termed a genius by the press, and his advertisements and direct mail efforts bring in all kinds of subscriptions. He's the man of the hour, and his only problem is which TV program to appear on, or which magazine interview he will submit to next.

But unfortunately, there's a catch. The catch to the genius syndrome is that most of the time the market refuses to fit the prediction. Then there's a period wherein the genius insists that the market WILL fit his scenario if we only give it time. Time passes, and the situation only grows grimmer. The advisor tosses in bed night after night. He curses the market, he curses whatever statistics or charts "threw him off course." He writes more reports still trying to justify his position. Finally, his accountant calls him and tells him that "it's all over." To make him feel better his accountant adds, "You wrote a great report, Charlie; they just didn't appreciate what you were trying to do."

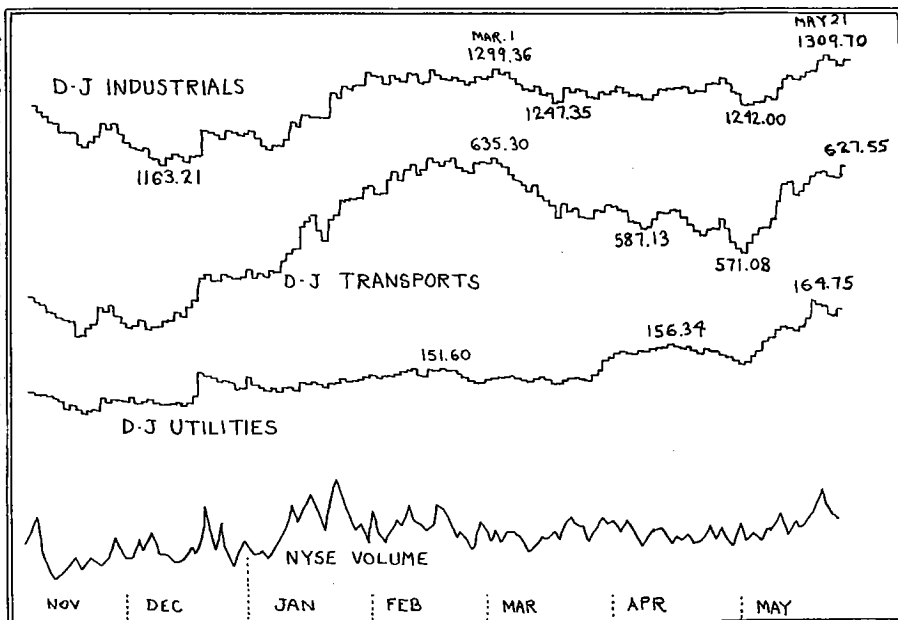
Of course, what Charlie was trying to do was be THE GENIUS, the hot hand, the guy who was right when everyone else was wrong. But where, where in the world did Charlie go wrong? Charlie went wrong by (1) having a scenario, a

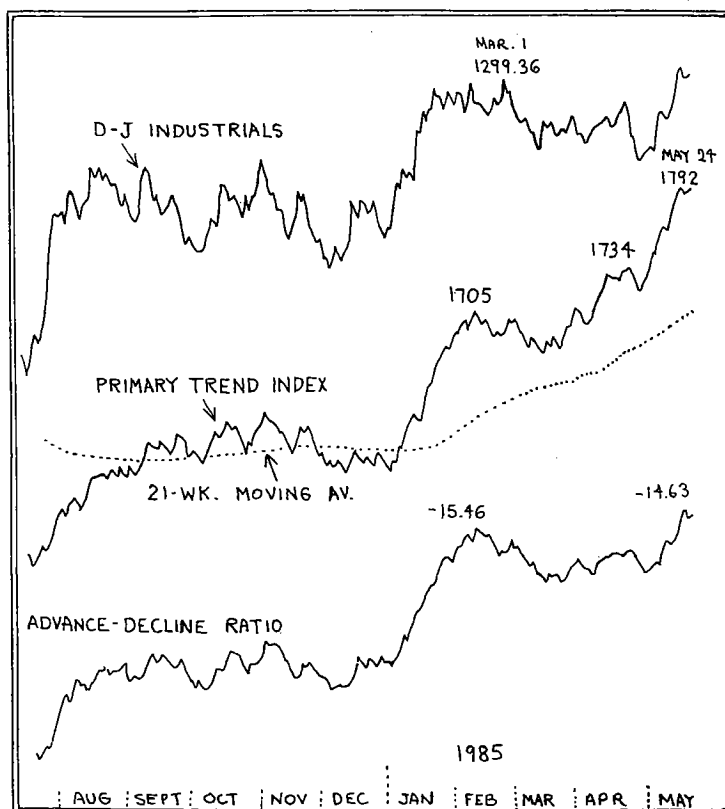
personal scenario which the market wasn't interested in honoring. Charlie went even more wrong by (2) trying to put a time element on his personal wrong scenario. (3) Charlie went very wrong by going public with his wrong, badly timed personal scenario. Charlie is selling appliances in Anchorage now. He's telling people that Anchorage is due for a major heat wave next November.

There are a lot of things I personally don't like about today's economy, and I go into a few of these in a later section entitled "Deficit Hypocrisy." But aside from my objections to this and that, the operative force today is that Wall Street is in the throes of a bull market. I developed the Primary Trend Index (PTI) and the "bull in the box" concepts to dramatize the overriding importance of the primary force in the market.

So I'll say it again; the primary trend of the market supersedes all other theories, opinions, concepts and considerations. While the primary trend of the market is bullish, you either buy a lot, buy a little or (if you want to be stubborn) you buy hardly at all. But you don't sell short--that's not stubbornness, that's stupidity and arrogance. All positions in a primary bull market must be in harmony with the bull trend. To operate against the prevailing primary trend is a one-way, sure ticket to bankruptcy.

According to the classic Dow Theory, the primary trend of the market is reconfirmed any time the D-J Industrial and Transportation Averages rally above preceding bull market highs. The bull market highs I have been referring to in Letter after Letter were the





1299.36 Industrial high of March 1 and the 635.30 Transportation high of the same date.

In the last Letter I noted that on May 10 both the S & P 500 Composite and the NYSE Composite rose to record highs. Then on May 17 the D-J Utility Average rose to a record high above its old 1965 high of 163.32. Were those record performances enough to reconfirm the primary bull trend? Under Dow Theory the answer is "no", since the S & P and the NYSE Composite and the Utility Average play no part in Dow's Theory.

But with the PTI roaring upward and with these broad composites surging to record highs, I felt that the primary bull evidence was clear enough. You just don't get record highs in major, broad composites during a bear market. What we've seen so far in 1985 is a market that has been providing plenty of worries for the bulls. But my PTI has kept me on the right side of the market throughout--even when the D-J Averages were reluctant to reconfirm the primary bull trend.

On May 20 the Dow finally came through. On that day the Dow closed above 1300 for the first time in history. The D-J Transportation Averages failed by almost 9 points to confirm (a confirmation would require a Transport close above 635.30).

Is the lack of Transport confirmation a danger signal? It could be, but as I have said so often, you have to give a bull market time. True, the best reconfirmations are simultaneous, meaning that both Averages rise to new bull market highs on the same day or perhaps a day or so apart. But the history of this bull market (maybe because too many neophyte technicians are scrutinizing it) is that the action tends to be very erratic. The composite indices go to new highs without the Dow, the Dow goes to new highs without

the Transports, the Utilities lag, the Utilities lead, the bonds slump, the A-D ratio lags.

Following is a list of items that I think are worth noting.

(1) The new Dow high of May 20 was accompanied by 454 new highs on the NYSE. This is the highest number since January and it confirms a good performance by "the rest of the market."

(2) The A-D ratio has broken out of its February-May trading range, and this is also good confirmatory action.

(3) The PTI (page 2 chart) led the way up during all of 1985. The PTI never got close to its rising 21-week moving average, and that kind of action constitutes picture-book bull action for the PTI.

(4) Robert Rhea (the great Dow Theorist of the 1930's) wrote that the primary bull markets are always international in scope. Along these lines, of eleven foreign stock markets that I follow, ten now show a positive 12-month performance. Examples: Australia is up 37% over the past 12 months, Britain up 30%, France 27%, Japan 21%, Canada 23%, Hong Kong up 77%, and so forth. The world indices, like the US indices, are bullish.

(5) A problem: The D-J Transportation Average has not yet confirmed the historic high in Industrials. A confirmation would mean a Transport close above 635.30. A major penetration by one Average, unconfirmed by the other, always bothers me. But as I said, a bull market is entitled to time.

(6) I run a 21-day moving average of the short-term trading index (known as TRIN or MKDS). When this 21-day MA gets below 1800 the market is overbought and upside progress becomes very difficult. That's where the market is now. The overbought condition must be worked off. It will be important for the Transportation Average to "hold together" while the overbought situation is worked off.

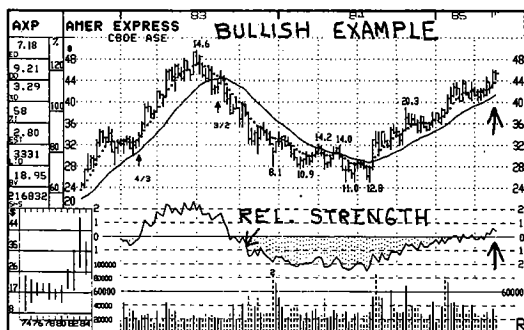
INVESTMENT POSITION: The bull is still king of the box. The market is overbought now, and it is facing the problem of a Transport non-confirmation. It may take a while for the whole situation to right itself -- but the operative thought is that a bull market reigns.



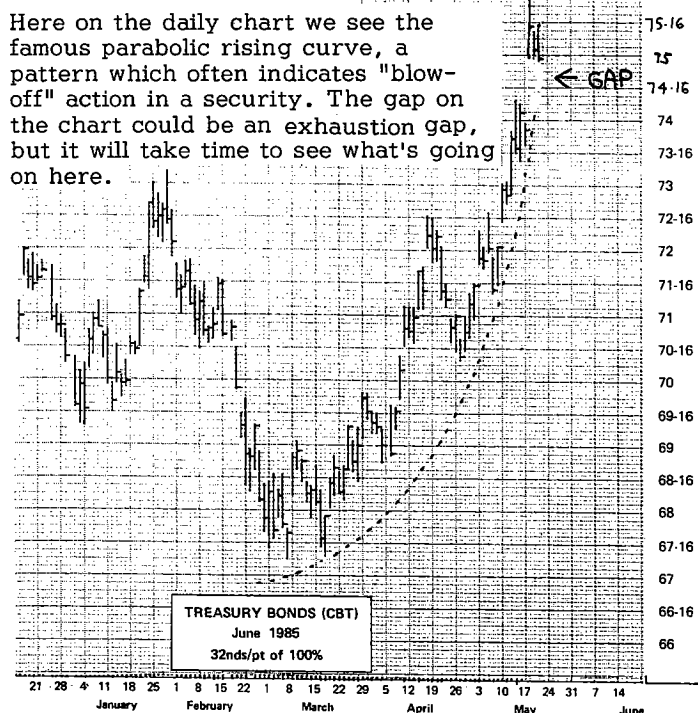
For stocks, I've been saying that by definition the Dow goes UP during a bull market. Therefore, to participate it makes sense to own the strongest Dow stocks. These are Amer. Can, Amer. Express, Amer. Tel., DuPont, Exxon, Gen. Foods, Owens-Illinois, Westinghouse, Woolworth. These oft-recommended selections are based on relative strength to the general market and the stock's position in relation to its own long-term moving average. If a stock is performing better than the market and also holding above its own recent average price, what more can you ask? That's the ultimate technical test of superior performance. The single danger here, of course, is that the stock's performance can change. If it never changes, we

would have the perfect system for getting rich without risk.

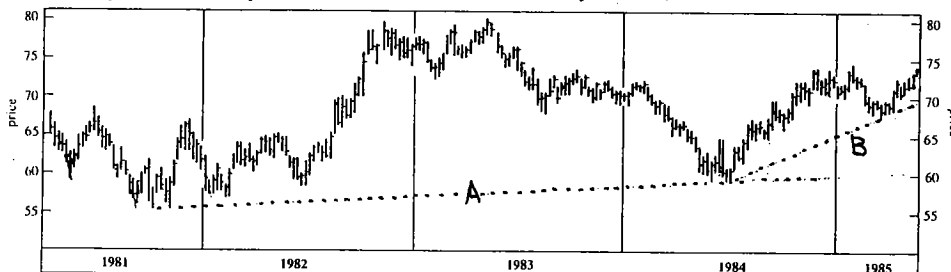
Bonds still look good, even though they are very overbought, and even though I am highly skeptical of Washington's budget-cutting efforts (remember, they are not cutting the actual budget, they are simply trying to cut the rate of deficit creation).



BONDS, RATES, COMPOUNDING: I've talked a lot about today's fat real interest rates. I've encouraged subscribers to buy bonds and particularly muni bonds. I've written repeatedly that the operative words for the rest of the 1980's will be "income, income, income." And subscribers who bought bonds at the 1984 lows (when I urged readers to buy them)



Treasury-bond futures' prices since the all-time bottom (nearby contract)



did indeed buy income and fat yields. The question: for those who want to compound, what do you do now?

I'm including here the chart of the June T-bond contract (courtesy of Dunn & Hargitt). Obviously, we've witnessed a big breakout and the bonds now are at three year highs. Could they go higher? Sure, but I'm a lot less enthusiastic about locking in yields today than I was at the 1984 bottom. At this point I would say that yield-buyers should do so very gingerly. This is not the place to load up on yield vehicles. Every yield vehicle that I've recommended over the past year from Tri-Continental preferred to the T-bonds to some of the closed-end bond funds are selling at the highs.

For a longer term perspective I am also showing this chart (from the excellent Grant's Interest Rate Observer, 233 B'way, NYC 10279). The chart is self-explanatory. Trendline A from the 1981 bottom defines the main bull trend of the T-bonds. Trendline B defines the more recent secondary bull trend from the 1984 low. Trendline B intersects at 70 on the T-bond futures. As long as the futures hold above 70, there is no question of the bull trend's being intact. A cracking of 70, and I would say that we're looking at trouble.

My advice now is to put large amounts of new money into three or six month T-bills, and just wait for further developments.

For smaller amounts of money, there are still a few good yields left in the closed-end bond funds listed on the NYSE. These bond funds are Intercapital Securities, John Hancock Investors, Current Income, American Capital Bond, Drexel Burnham Bond Fund. These are all bond funds that trade like common stocks in that when you buy shares in them you are buying shares from another holder just as if you were buying shares in GM or American Telephone.

It is well to remember that when I advocated loading up on bonds back in mid-1984 that was a contrary opinion. Now everybody is convinced that rates are coming down and that bonds are a buy. It feels very "easy" to buy bonds today. As a rule, whenever it feels easy to buy any security, that security is NOT on the bargain table. That's the way I feel about bonds today (even though I personally haven't sold any of the bonds that I bought since the 1984 lows).

DEFICIT HYPOCRISY: I'll say it once more: (1) This nation is compounding itself into bankruptcy via debt. (2) President Reagan isn't telling the American people the real story. (3) Congress is playing games with itself.

On page 4 we see the latest rundown on the government figures. Note that the total public debt as of May 17 was \$1.75 trillion. In a year or so the debt

will hit the unbelievable figure of \$2 trillion. Personally, I think it's a disgrace! Now look at the third column. The interest on the federal debt through March or through the first six months of the fiscal year was \$87 billion. That means we're running at the rate of about \$170 billion a year in

Government Finance

WASHINGTON (AP) — Here are figures on government spending and debt (last six digits are eliminated). The government's fiscal year runs Oct. 1 thru Sept. 30.

Total public debt May 17	1,752,462
Interest on public debt Mar	12,726
Interest fiscal year thru Mar	87,577
Projected deficit fiscal 1985	203,021
Actual deficit fiscal 1984	175,342
Receipts fiscal year thru Mar	340,228
Receipts period last year	304,291
Outlays fiscal year thru Mar	468,332
Outlays period last year	422,965
Gold assets thru Jan	11,095

Deficit Up 9% From '84 Despite April Surplus

WASHINGTON (AP)—The government enjoyed a rare monthly budget surplus last month, courtesy of a surge of money from tax returns, the Treasury Department reported Thursday.

The April surplus of \$12.37 billion still left the total deficit for the fiscal year at \$115.74 billion, 9% ahead of the level at this time last year.

The Reagan Administration is forecasting a record deficit of \$203 billion for the current fiscal year, 16% higher than last year's \$175.34 billion.

is stagnant. For the first quarter of 1985 the GNP rose a piddling .7%. What is that telling us? It's telling us what I've been saying all along--the huge deficits are now DEFLATIONARY. The cost of carrying all the US debts is finally acting like a monster sponge, sopping up money, sopping up the life blood of the economy.

All right, what about the hypocrisy? I think we're seeing it in Washington now. Consider this: Roosevelt exercised his veto power over 500 times during his term of office. So far, President Reagan has used the veto less than 30 times. Yet, Mr. Reagan keeps complaining about the deficits. Obviously, most of the complaining is talk. Reagan's deficits have been the greatest in US history, and he has literally abandoned his veto power (all the while complaining that Congress won't help him).

What about the Fed and Mr. Volcker? Almost every time Volcker goes before Congress he warns about the deficits. But it is the Fed that finances those deficits. The fact is that Congress keeps spending far more than the Treasury takes in, and the Fed plays the game by financing the deficits year after year.

It is estimated that the US now has a total (federal, state, corporate, personal) of \$7.1 trillion in debt. Figuring that average interest on this mountain of debt is 10%, it now takes \$700 billion a year to carry this debt. This unbelievable interest burden is the reason (in my opinion) why, despite continued debt creation, we do not see high rates of inflation today. The debt is sopping up liquidity almost as fast as the Fed can create it.

INTEREST on the federal debt. And that means interest cost of well above \$3 billion per week! On top of that the deficits and total debt keep climbing, and the compounding continues, and continues.

Here's another thought. Federal deficits tend to be stimulative to the economy, since a deficit implies that the nation is spending more than it is taking in. Twenty years ago a deficit of \$150 to \$200 billion (such as we are generating today) would have sent the economy spinning into space. It would have been wildly stimulative. But what of today? Today, with deficits in the \$200 billion and up class our economy

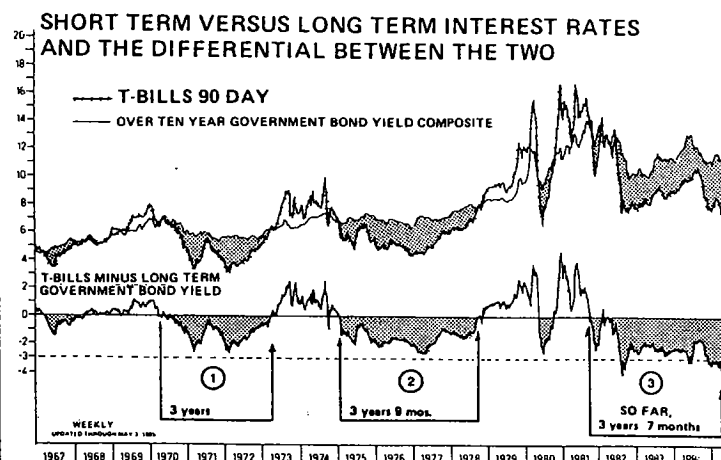
During the 1960s and '70s the ratio of total domestic indebtedness to GNP ran about 1.4 to 1. In other words, it required a rise of roughly \$1.4 in debt to produce an increase of \$1 in GNP. Today, the ratio has changed. The year 1984 saw domestic debt rise \$715 billion to produce an increase of \$360 billion in GNP. That was a ratio of 3 to 1, \$3 in domestic debt to produce \$1 of increased GNP.

This is the basic reason why we can now run deficits of \$200 billion and more even while the economy is sluggish, even while economists debate about whether the nation is in a partial recession or not.

The real danger of this whole equation is as follows: the cost of carrying gross US debt continues to rise, the variables being the level of the debt and prevailing interest rates. But the carrying costs MUST be paid. On the other hand, the GNP is subject to major changes. During the Great Depression, for instance, GNP at one point dropped 50%. With that in mind, the danger in the equation can immediately be seen. And that danger will arrive with the next US recession.

Given the amount of debt now in the US economy, any recession that reduces GNP as much as 10% would set off such a scramble for liquidity that it would bring back memories of 1929. Mere hints of this kind of emergency can be seen in the farm situation over the past year or so.

I want to include one chart which has me wondering at this point (chart courtesy of Aden Analysis, 4425 W. Napoleon Ave. Metairie, LA 70001). I've written recently about the very wide spread between T-bill yields and T-bond yields. The T-bill yield is based to a large extent on current liquidity conditions, Fed desires and current demand for money. But the T-bond yield is based on investors' perceptions of inflation, long-term risks as well as perceptions about deficit control.



This chart shows that compared to 1970-73 and 1975-78, something different is happening today. Note that in 1973 bill rates moved above bond rates, and this occurred again in 1978 (this is the so-called negative yield spread, brought on by pressure for funds in the short-term money market).

But right now, after more than three years of "economic recovery," the bonds are still yielding near 4% more than the bills. Why? The answer is that consciously or unconsciously the bond market is very much aware of the rising US debt and the rising cost of carrying that debt.

The still spectacular spread between T-bill and T-bond yields is telling me that long-term bond buyers, people who have to take a big chance on the future, these people are still far from pleased with the way the US debt situation is going. Therefore, they are very reluctant to pay fat premiums for long-term bonds -- even though short-term rates have come down 50% from their highs of a few years ago.

BACK: We're back from our whirlwind, one-week visit to New York. Weather was perfect, and the only disaster was the United Airlines strike. You can call NYC "Yuppie-ville" now. And where it's happening is on New York's West Side: Amsterdam Avenue, Columbus Avenue in the 70s and 80s. Columbus (in my day a semi-slum) now has about 10 restaurants per block. Everyone is sitting around outside eating pasta, luxury salads and sipping decaf or the latest wine. The West Side has become the new center of the civilized world. It's so upscale, it shimmers.

Prices of West Side brownstones that were \$30,000 when I got out of the Air Force in 1945 are now \$1 million and up. New buildings are popping up like mushrooms, fancy little clothes shops and boutiques dot the landscape. New York is in the throes of a super real estate boom. In contrast to the rest of the country, house prices in NYC have jumped 24% over the last year (first quarter to first quarter).

On the staid East Side not that much has changed. Except that I was amazed at the sheer number of "stretch" Cadillacs that literally line the streets. The new measure of success in New York is the stretch and your personal chauffeur. Gotham is very trendy, and the second sign of success is the ability to be seen at the best Broadway show, the latest museum opening or the newest and hottest restaurant or dance palace.

The vibrations of New York have changed since I was there last. The new vibrations are "peace and prosperity." Everybody is buying, everybody is rushing somewhere, everybody is dealing. I felt no danger signals when walking through the city, even late night. At midnight the City is still popping. Well dressed blacks lined up on East 57 and 58 Streets at midnight, evidently waiting to get into various East side discos. I used to get eerie feelings any time I walked around NYC after 11PM. No more, the vibrations are warm, and NY's feeling good.

The restaurant scene (nationwide) is now a branch of show business. In NYC popular restaurants have long waiting lists, regardless of price. Restaurants we went to included La Tulipe in Greenwich Village (outstandingly good), famed Le Cirque (food disappointing), four-star Lutece (a great restaurant and wildly expensive), Cafe Manhattan (extraordinary filet and lobster), Russian Tea Room (place to be seen, food fair), and Woods on Madison Avenue (a sleeper serving the best pasta I've had in years). As an antidote for rich food, we skipped breakfasts and lunched daily at Dokasan, a low calorie Japanese noodle chain.

Visited many museums, the outstanding ones being the Morgan Library with an historic collection of drawings and MOMA with the fabled Rousseau collection. Also visited the floor of the New York Stock Exchange, courtesy of old friend Herman Weiss, who is now director of all floor trading for Shearson-American Express.

Around the fifth day I started dreaming about sea breezes, the Pacific Ocean, grass, parking spots and a landscape unpolluted by taxi horns and police sirens. By May 18 I was home. I celebrated by planting a row of beefsteak tomatoes and defleaving the bull terrier.

A final comment: when I returned to La Jolla, I was struck by the change in national communications. I feel every bit as in touch with the markets here in California as I did in NYC. The world is just a lot smaller now. And I get the Wall Street Journal at 4AM in La Jolla, hours before I could get it in Gotham. I told myself that I may never leave La Jolla again (except for June 14 when I'll be on Financial News Network for a full hour starting at 1PM).

NOTES & QUOTES: Russell Baker of the New York Times writes a lot of funny columns. Last week he wrote on today's banks, and I thought a few excerpts would be worth repeating:

Going to the bank nowadays is more fun than it used to be. For one thing, you never know whether the bank will run out of money before you get there.

"Never a dull moment." That's the motto of my bank, which is the First High Rollers & Go-Go National Trust. As the name suggests, it's a friendly, relaxed bank staffed by friendly, relaxed bankers.

I liked it the first time I glanced in and saw the vice president in charge of investments reading The Racing Form, so I walked right in, introduced myself and asked to open an account.

The teller said, "How much?" and I said, "Fifty dollars," and he said, "Every little bit helps, but next time we'd appreciate it if you could bring a couple of hundred thousand as we could get into a really big deal in

swamp real estate if we had a little dough."

"A little dough." Here was my kind of bank at last. A bank where the tellers called it "dough."

Yes, the U.S. Government will step in if the fun gets too high-spirited, just as it stepped in when E.F. Hutton started edging out of the stocks-and-bonds racket and into bank robbery.

All of us who like fun at the bank will miss the Hutton mob. They didn't look much like John Dillinger or the Mafia man with cash for the bank to ship to Switzerland, and that was their charm.

How amusing to see bank robbers in three-piece suits. To Ed Meese's credit, he didn't use his clout as Attorney General to lock up any of them. Ed is a good sport, which banking needs. □

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My old friend, Don Bauder, business editor of the San Diego Union, has just come out with a fine new book entitled, "Captain Money and the Golden Girl" (Harcourt Brace). This is the story of one of the greatest Ponzi schemes since Ponzi, and, of course, much of it took place in La Jolla. The chief characters are little Jerry Dominelli and statuesque, blonde Nancy Hoover. These two (with help from their friends) extracted over one hundred million dollars from gullible San Diegans and others--all in the name of greed and getting rich quick.

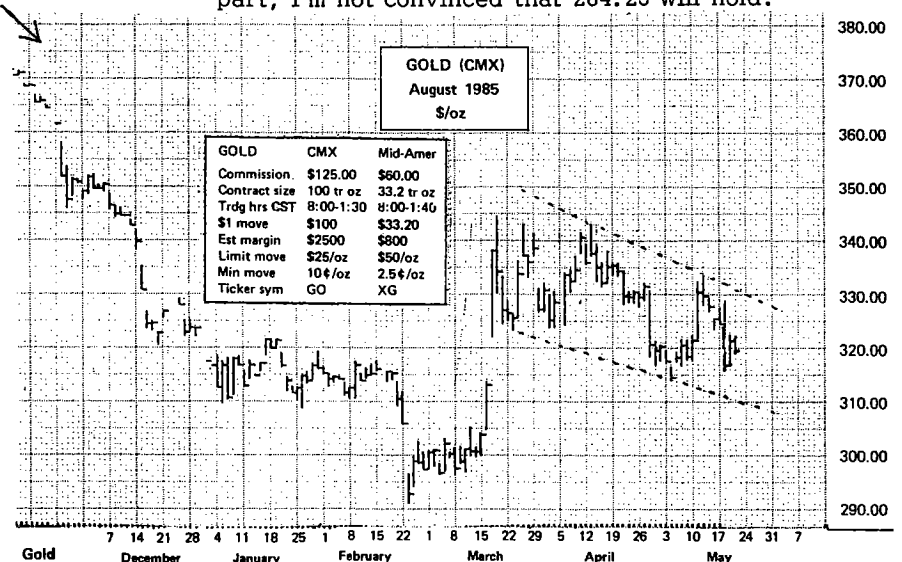
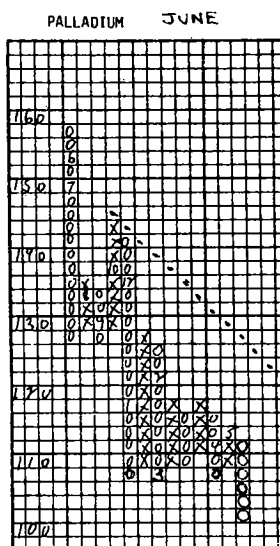
Don writes the story with the skill of a trained newsman and the knowledge of a business editor. The book is a fantastic chapter in the history of great con games. Anyone who has ever dreamed of getting rich the easy way should read it. I couldn't put the book down (it's always fascinating to read about someone ELSE who has lost his money as long as it isn't you!).

Don't get me wrong, I voted for Ronald Reagan, and I like him. But my complaint is that he talks tough and then settles for ANYTHING. Reagan wants to increase the military. Give him a 6% increase -- "fine". How about a 4% increase -- "OK". No increase, just an inflation boost of 2.5% -- "Great, I'll take it." No boost at all -- "Sure, if that's the best I can do." Hey Mr. President, how about cutting the military in half and trading in the Navy for six armed row boats? "Well now, I'll have to think about that. Mind if I talk to Mr. Regan?" C'mon Ronnie, get tough. Make our day.

One of the pleasantest and prettiest cities in North America is Vancouver, B.C. I'll be speaking there August 11-14 along with many others. For info, write to Investment Seminars, Heritage Building, 1859 Main St., Sarasota, FL 33577 or (813) 955-0323. More later.

Believe it or not, a lot of real, honest-to-goodness gambling takes place outside of Wall Street. Maybe the pots aren't as big as the Street's pots, but they're big enough. On May 24 in Las Vegas, 140 players plopped down \$10,000 each to enter the World Series of Poker at Binion's Horseshoe. The play lasted 24 hours, and the final pot was \$677,000. Two players remained, Bill Smith of Dallas and T.J. Cloutier. The game was no-limit Texas Hold-em. The players were each dealt two cards down. Cloutier then bet everything he had, \$309,000. The rest of the cards were dealt. Smith called, and his hand was the better. Smith kept \$700,000 as top prize. Cloutier got second prize, \$280,000. Smith also got most of the winnings from the other players, estimated at \$1.4 million. Those Texans are tough!

GOLD: Here's an updated daily chart of gold courtesy of Dunn & Hargitt. We see that gold has been moving sideways since March, and a large pennant-type pattern has formed. On the August contract a break



LATE NOTES: May 24: The Dow records its highest weekly closing in history, 1301.97. The PTI is still leading the market up, closing the week at a 1985 high of 1792 (see page 2 chart). Bonds remain strong, and commodities remain weak, the CRB Index closing the week at a three-year low of 234.5. Precious metals show weakness with platinum and

below 314 would look bearish, and a rally above 335 would brighten the picture. Personally, I'm still not impressed with the gold action.

Howard Ruff is writing very convincingly these days about the coming hyper-inflation. I've argued with Howard about this ever since 1980. Howard could be very right and I could be dead wrong. But Howard's argument is that the US is still spending its fool head off, and that ultimately all these deficits will be "financed" by the Fed via monetization of the debt -- which is inflationary.

My argument is that the debt is now so huge, so unwieldy, that its deflationary power is overcoming the inflationary force of the Fed's pumping. Certainly the commodity charts look poor today. The grains are in a bear market, the meats are hanging on, sugar and cocoa are terrible, oil is weak again and what's left -- orange juice? The OJ is falling out of bed too.

Palladium tends to be a leader in the metals, and for what it's worth, palladium has just given a bearish signal. This point & figure chart (courtesy of Chartcraft) shows the June Palladium contract breaking a quadruple bottom as it slides down to the 102 area. What palladium is doing now is certainly NOT inflationary.

In the meantime, the widely-followed Commodity Research Bureau index of 27 commodities is down to 235.0, a new low since 1982. Finally, my gold-to-common stock ratio has reversed in favor of common stocks. This mode on the ratio has never been bullish for gold.

So what's my conclusion? It's the same conclusion I've been espousing here for the last few years. Inflationary signs in the American economy are largely absent. The bearish trend of the precious metals and most commodities attests to this view. The biggest hope for the inflationists is that the February '85 low of 284.25 for gold will prove to be THE low. For my part, I'm not convinced that 284.25 will hold.

palladium leading the way down, gold and silver trying to resist the deflationary down-drafts. On Wall Street one fact holds sway -- it's a primary bull market, and it's grinding away on the upside.

NEXT MAILING: June 12